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Federal Reserve Bank of Philadelphia

Elements of a Sound Funding and Liquidity Risk Management Program, Part I

by Andrea Anastasio, Senior Specialist, and Mark Kemmerer, Specialist

On March 17, 2010, the federal banking regulators issued SR Letter 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management*, to provide financial institutions with consistent interagency guidance on the principles of sound liquidity risk management.[1] Given the turbulence in the financial markets over the past two years and the continued deterioration in asset quality, earnings, and capital at many institutions, strong liquidity risk management practices are more important than ever. However, examiners have found that liquidity risk management programs at many financial institutions continue to be less than adequate. This is the first of two articles highlighting pertinent items included in the guidance and discussing some of the approaches that examiners may enlist when evaluating an institution's liquidity risk management program.

Liquidity risk management programs should include processes to address both current and future funding needs and to provide a system to identify and manage unexpected liquidity events. Failure to maintain an adequate liquidity risk management process is considered an unsafe and unsound practice. Several elements need to be included in a sound liquidity risk program. These include the following:

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk
- Appropriate strategies, policies, procedures, and limits to manage and mitigate liquidity risk

[1] SR Letter 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm>.

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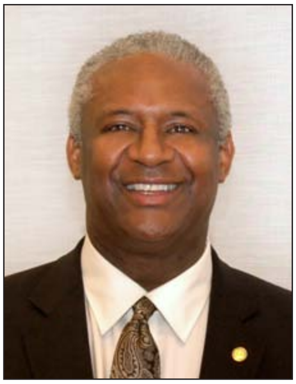
FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Prime Time Performance: Trends in Prime Conventional Mortgages

by Michael E. Collins, Executive Vice President



The performance of prime conventional mortgages, a staple of most community bank portfolios, has suffered greatly over the past two years. The deep and protracted recession, accompanied by high unemployment and declining house prices, has strained many borrowers' capacity to make payments and has driven delinquencies in this traditionally benign loan type to unprecedented highs.

Vigilant monitoring of local and national level prime mortgage data remains important, since these mortgages generally represent a large segment of a bank's overall loan portfolio and because improvement in credit quality typically tends to lag economic recovery. Mortgage performance metrics can also provide valuable insights into broader economic influences, such as housing market conditions, construction starts, and consumer purchases of large ticket items.

Emergence of Problems

Subprime mortgage delinquencies drew most of the attention during the initial stages of the financial crisis. Their rapid deterioration stemmed largely from lax underwriting standards and inappropriate usage of innovative mortgage products. Third District banks were generally more conservative and did not originate material amounts of subprime or nontraditional loans. However, as local house prices declined and broader economic stresses emerged, even soundly underwritten prime mortgages faced considerable stress.

Delinquency rates in subprime and prime mortgages exhibited similar directional trends, albeit on a dramatically different scale. In March 2010, total subprime past dues (including foreclosures) at the national level reached 50.4%, while the prime category stood at 10.8%. Historically, these categories had averaged around 4.0 percent and 0.50 percent, respectively.

When measured in terms of year-over-year change in delinquencies, the pace of prime mortgage deterioration now eclipses that of subprime. Tighter underwriting standards have improved the most recent vintage of loan originations, but concerns linger about rising levels of severely delinquent loans that are not yet in foreclosure.

Third District Metrics: Historical Performance

Our analysis of Lender Processing Services, Inc. (LPS) Applied Analytics data shows that prime first lien mortgage delinquency rates in the Third District rose sharply, but remained consistently below national averages throughout most of the crisis.[1]

Notably, prime mortgages originated with fixed rates have performed considerably better than those with adjustable rates.To illustrate, at year-end 2009, prime ARMs in the Third District had a 90-day plus past due rate of 12.1% versus only 4.9% for fixed-rate loans.

Third District Metrics: Recent Performance

March 2010 LPS data indicate that, in total, 9.47% of first lien prime loans in the Third District were past due (including foreclosures). Although well above historical norms, this was considerably lower than the comparable 10.68% for the nation.[2] The underlying LPS data used in these delinquency rate calculations include both agency and nonagency loans. While credit risk may be more apparent in balances held directly on the bank's balance sheet, other potential exposures arising from involvement with securitized transactions should also be considered.

However, early stage problems may still be building. The 2.74% of loans with installments that are 30–59 days past due now exceeds the corresponding U.S. rate of 2.57%. Furthermore, the 1.14% of loans that are 60–89 days past due is very close to the national level of 1.18%. (See Chart A: Delinquency Rates for First Lien Prime Loans.)

The 10 counties in the Third District with the highest first lien prime mortgage total past due percentages (including foreclosures) as of March 2010 were Monroe (PA 18.58%), Cumberland (PA 15.93%), Salem (NJ 14.70%), Atlantic (NJ 13.95%), Pike (PA 13.73%), Camden (NJ 13.12%), Carbon (PA 12.82%), Philadelphia (PA 12.20%), Kent (DE 11.95%), and Ocean (NJ 11.84%). (See Chart B: Prime Mortgage Performance by County.)

All of the Third District's prime loan categories showed significant year-over-year deterioration during 2009, but it was the jumbo prime mortgages that deteriorated at the fastest pace. Seriously delinquent loans in this category accelerated rapidly and experienced a nearly twofold increase. (See Chart C: 2009 Year-Over-Year Percentage Change in Delinquency Third District Loan Types.)

Factors Contributing to Delinquencies

High unemployment has likely been the key factor contributing to the recent rise in delinquencies. The labor market was particularly hard hit by the recession. In March 2010, unemployment rates were 9.0% in Penn-

[1] LPS is a provider of mortgage processing services, settlement services, and default solutions, as well as integrated data, servicing, and technology solutions. For more information, go to <www.lpsvcs.com/Pages/default.aspx>.

[2] The underlying LPS data used in these delinquency rate calculations include both agency and nonagency loans. While credit risk may be more apparent in balances held directly on the bank's balance sheet, other potential exposures arising from involvement with securitized transactions should also be considered.

sylvania, 9.2% in Delaware, and 9.8% in New Jersey.

The fact that our region did not experience the extent of house price "boom and bust" witnessed in other areas of the United States (e.g., Georgia, California, and Nevada) may have actually helped mitigate the overall severity of problems in our area today. The number of local "underwater" homes, i.e., instances where the borrower is in a negative equity position and owes more than the house is worth, remains significantly lower here than in other parts of the country. For example, First American CoreLogic data as of the fourth quarter of 2009 indicate that the percentage of mortgaged homes with negative equity in PA (7.5%), NJ (16.1%), and DE (14.3%) remains well below the national level (23.8%).[3] By contrast, in the particularly hard hit state of Nevada, a remarkable 69.9% of homes had a negative equity position. (See Chart D: How Are Third District States Faring?.)

Looking Ahead

Bankers should continue to actively monitor mortgage loan performance and real estate market conditions. Reliable and timely data can inform lending decisions, help shape strategic direction, and better position a bank to seize opportunities as the recovery takes shape.

The Federal Reserve has made efforts to facilitate the information gathering process and improve public awareness of U.S. credit conditions. The New York Federal Reserve offers comprehensive data on current consumer credit conditions in the United States through its public website at <data.newyorkfed.org/creditconditions/>.

The financial crisis has caused great hardship for many families and communities. The protracted and deep recession has exacted its toll on even the most creditworthy borrowers. Throughout this time, Third District community bankers have demonstrated a good understanding of their customers' needs and a willingness to work through problems constructively. As Chairman Bernanke said in a recent speech, "Achieving the appropriate balance between necessary prudence and the need to continue making sound loans to creditworthy borrowers is in the interest of banks, borrowers, and the economy as a whole." ☐

[3] *State-by-State Estimates for U.S. Single-Family Residential Properties*, available online at <www.facorelogic.com/newsroom/marketstudies/negative-equity-report.jsp>.

[4] Chairman Ben S. Bernanke, *Economic outlook*, Before the Joint Economic Committee, U.S. Congress, Washington, D.C., April 14, 2010, available at <www.federalreserve.gov/newsevents/testimony/bernanke20100414a.htm>.

CHART A

Chart A: Delinquency Rates for First Lien Prime Loans March 2010

Percent of Loans with Installments Past Due

	Third District	Entire DE	Entire NJ	Entire PA	United States
Total Past Due *(Including Foreclosures)*	9.47	9.23	11.33	8.44	10.68
30 to 59 Days	2.74	2.57	2.54	2.69	2.57
60 to 89 Days	1.14	1.20	1.14	1.09	1.18
90 Days or More	3.23	3.12	3.65	3.00	4.11
Foreclosure	2.36	2.34	4.00	1.67	2.81
Seriously Delinquent *(90+ and Foreclosure)*	5.59	5.46	7.65	4.67	6.92

CHART B

Chart B: Prime Mortgage Performance by Country
First Lien Prime Mortgages: Total Past Due

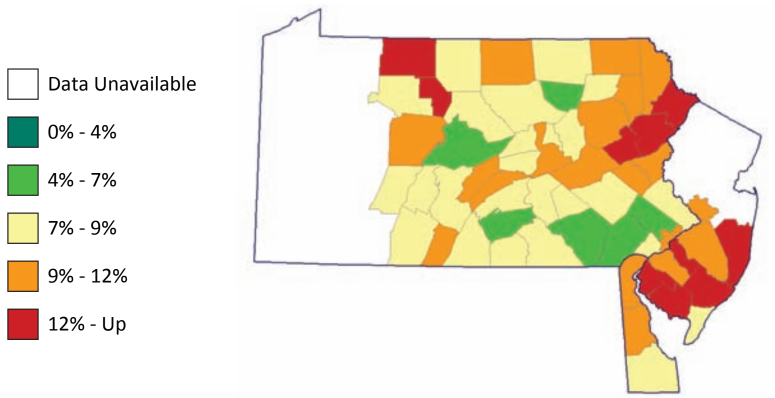


CHART C

Chart C: 2009 Year-Over-Year Percentages Change in Delinquency
Third District Loan Types

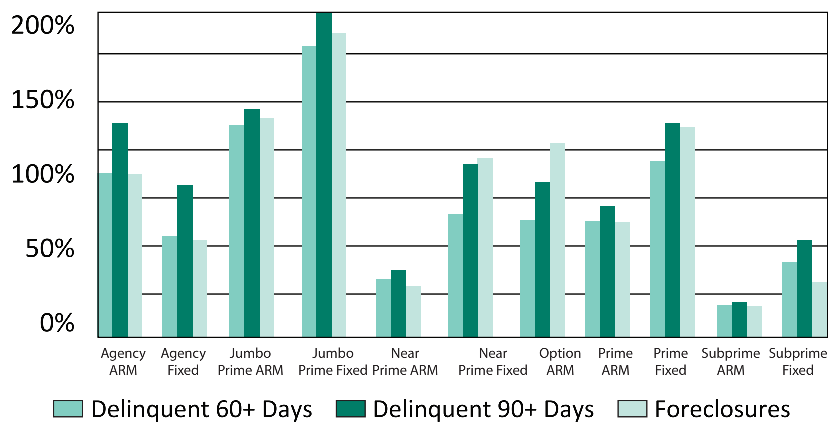


CHART D

Chart D: How Are Third District States Faring?

Percent of Loans with Installments Past Due

Source: BLA, FHFA, First American Corelogic, RealtyTrac	PA	NJ	DE	NV	US
Unemloyment Rate (March 2010)	9.0%	9.8%	9.2%	13.4%	9.7%
FHFA 4Q09 House Price Index: One Year Change	-0.5%	-3.7%	-3.8%	-17.3%	-1.2%
FHFA 4Q09 House Price Index: Five Year Change	13.1%	1.51%	6.20%	-40.4%	1.66%
% Homes with Negative Equity (2009 4Q)	7.5%	16.1%	14.3%	69.9%	23.8%
Foreclosures Q1 2010 (1/every X households)	1 in 374	1 in 226	1 in 324	1 in 33	1 in 138

From the
Examiner's Desk

Commercial Real Estate Loan Management: Supporting Successful Restructuring and Loss Mitigation Strategies

by Sharon D. Wells, Examiner, and Ralph Acevedo, Examiner

Recent national and Third District indicators suggest that problem loan levels continue to rise. In response to this trend, the first quarter 2010 issue of *SRC Insights* presented an overview of 2009 regulatory guidance, *Prudent Commercial Real Estate Loan Workouts* (the guidance), to assist institutions with dealing with problem loans.[1] The guidance stressed that financial institutions will not be subject to criticism for engaging in thoughtful restructuring activities, even if the loan continues to remain adversely classified or if a collateral deficiency exists. It is recognized that restructuring is an important part of loss mitigation. Successful restructuring is predicated on early detection and the availability of information. Accordingly, this article emphasizes proactive, simple measures that financial institutions can employ to build strong problem loan management activities to help mitigate potential loan losses.

Typical workout strategies can take on a variety of forms and can be quite creative depending upon the negotiation skills and loan structuring skills of the lender and the willingness of the borrower to work with the bank. Most lenders are realistic about the fact that in today's environment, the prospects of a third-party take-out of a problem loan or a loan that is substantially over-leveraged are limited. This is likely to become even more challenging when a significant supply of loans reaches maturity over the next several years. According to the Congressional Oversight Panel's February Oversight Report, *Commercial Real Estate Losses and the Risk to Financial Stability*, "between 2010 and 2014, about $1.4 trillion in commercial real estate loans will reach the end of their terms, and nearly half are, at present, "underwater," i.e., leverage exceeds the value of the property."[2]

Furthermore, the report indicates that "the largest commercial real estate loan losses are projected for 2011 and beyond" as loans reach maturity. Current lending practices suggest that the level of equity required by lenders has increased substantially, so the prospects for a third-party take-out will be unlikely for a project whose LTV exceeds statutory limits or policies or is more than 100%. This also presents other problems for institutions holding high levels of OREO. The likely result will be further write-downs and longer property-carrying periods as seriously over-leveraged properties are added to market inventories. This will not only increase competition, but it will also further depress comparable sales statistics used in refinance valuations. As a result, institutions may be forced to enter into more restructures until valuations are stabilized.

The authors recognize that every institution will have its own unique set of challenges when developing restructuring or workout plans, and that each situation is different. Therefore, the remainder of this article will focus on simple suggestions to strengthen problem loan management programs in nearly any institution.

Focus on the Future, Not the Past

All too often, bank management can become entrenched in allocating blame for a situation rather than deploying energy toward correcting the problem. As a result, bank staff may spend a great deal of time

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[1] SR Letter 09-7, *Prudent Commercial Real Estate Loan Workouts*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/>.

[2] Congressional Oversight Panel, February Oversight Report, *Commercial Real Estate Losses and the Risk to Financial Stability*, February 10, 2010, page 2, Executive Summary.

defending historical assumptions or ideologies, rather than focusing on corrective measures. Diagnostics should not be dismissed so that lessons are learned, but they should be emphasized only in terms of shaping future policies and corrective measures.

If competency is not an issue, then the board of directors and senior management must promote an environment that is supportive and remains focused on the future and the task at hand. It is essential that lending staff remain open and focused on solving problems and feel free to communicate issues without fear of retribution. Otherwise, a problem may go unaddressed until it has reached a level that is no longer correctible.

Don't Lose Sight of the Performing Portfolio

As loan problems increase, it is understandable that may institutions will focus on and deploy resources to deal with the identified problem loans that have the potential to result in future loss. However, institutions should encourage lending staff and portfolio managers to use this time when business development opportunities are diminished to visit and monitor performing customers. This is a perfect time to obtain missing financial information and scrub collateral files to ensure that there are no emerging or underlying issues that could change the course of the performing portfolio. Just because a problem has not yet manifested itself does not mean that it is not on the horizon. The emphasis should be on getting ahead of a problem before it actually becomes one.

Diversify Managing to Delinquency

Institutions commonly use delinquency as the primary indicator that a borrower may be having problems. This is often the most efficient approach, particularly for loans in smaller pools where the risk is more diversified and the impact relative to capital is less severe. Community banks typically have a much lower threshold for individual credit loss; therefore, it is important that delinquency alone is not the trigger that prompts the development of a workout plan or a loss mitigation strategy. Mere management of problem loans through delinquency trends can obscure underlying issues that go undetected without regular portfolio due diligence. Making sure the problem is addressed before it manifests itself in delinquency and default is key.

There are a number of other factors that should prompt an organization to be on alert and place borrowers who are demonstrating potential signs of distress on the "watch" list. Financial warnings are generally easy to detect, and most institutions, provided they are receiving financial information and reviewing it regularly, are sensitive to negative shifts in financial performance. However, other less quantifiable considerations should also serve as early warning signs (some more general and others more project-specific), including the following examples:

- The failure to issue financial statements in a timely manner, if at all
- A change in the access to and availability of the borrower
- A revolving management team or equity partners
- Unauthorized changes in contractors, consultants, property management firms, or other vendors associated with the project or property
- Unanticipated cost over-runs or project delays
- An abrupt shift in the project plan
- Increased levels of deferred property maintenance
- Real estate tax delinquencies

In today's economic times, it is important that lenders develop keen radar for potential problems well in advance of a delinquency or default event. Identifying weaknesses before they become an actual problem will provide a broader window of opportunity to employ corrective strategies.

Ensure the Availability of Current, Accurate, and Comprehensive Information

The guidance also stresses that the success of a restructuring program is largely dependent upon the degree to which information is readily available. Institutions with solid information management systems that track and aggressively manage information deficiencies for performing portfolios will be better positioned to develop the most comprehensive strategies for loss mitigation when problems arise. Essential tools in negotiating and constructing a meaningful restructuring arrangement include the following:

- Current financial information
- Rent rolls and operating statements
- Recent sales experience
- Current appraisals
- Market trends
- Insurance and tax delinquencies
- Comprehensive data regarding third party affiliates and loan obligations
- Contingent liabilities
- Availability of alternative cash flow or collateral support

The ability to work toward a quid pro quo for any concessions that may need to be made as part of the restructure depends on the degree to which information can be obtained. Access to a comprehensive palate of information during the workout and term renegotiation process is extremely important and helps lenders to reduce the potential of leaving something on the table. It also ensures that compensating arrangements can be nuanced through the restructuring arrangement.

Routine "scrubs" of such key information as financial statements and collateral documentation are essential. Valid assignments of leases, UCCs, recorded mortgages, guarantees, licenses, landlord waivers, permits, etc. are necessary to mitigate loss; therefore, this process should not be compromised. Institutions with low exception levels will be exponentially better positioned when problem loans arise and will ensure that lenders and workout professionals have all of the tools needed to backstop an effective strategy.

Information provided by borrowers in a workout situation should also be checked, if possible, particularly if the borrower has been somewhat uncooperative. A review of public records or courthouse records can verify secured interests, judgments against the borrower, and bankruptcies and can possibly uncover hidden assets or undisclosed or fraudulent conveyances.

Emphasize Site Visits and Property Inspections

Implementation of a systematic property inspection program and a tax and lien monitoring program is also an important component of portfolio management that can have a substantial impact on the outcome of a problem loan situation.

The practice of periodic and frequent property site inspections should be implemented for properties securing both the performing and nonperforming portions of the portfolio. Properties with seemingly high occupancy rates and strong resulting net operating income (NOI) may have, in fact, experienced losses that could go undetected through entire financial or loan review reporting cycles. Loans that have remained current may be supported by sponsors who have little to no expendable resources remaining, and default may actually be imminent. Inspections will also identify unauthorized changes in use or missing collateral that will result in loss.

Covenants in Restructuring Arrangements

Performance covenants are also key ingredients of a restructuring arrangement. Covenants will provide the lender with a future opportunity to revisit the success of a restructuring program before a loan reverts back to a default. Successful restructurings require ongoing attention, and the process should require that loans are aggressively monitored well beyond the restructuring period. In addition to obtaining frequent, periodic financial information to support the success of the restructure, use of covenants, such as debt coverage ratio, minimum sales/absorption requirements, stabilized occupancy requirements, leverage limits, distribution limits, minimum liquidity requirements, etc. will enable the institution to bring the borrower back to the table to address any issues not anticipated in the restructure.

Lenders should restrict cash flows from being redirected outside the project, particularly to other problem loans a borrower may have at other institutions. Restructuring should require some level of "ring-fencing" that ensures that funds are not deployed elsewhere. To this end, operating accounts for the subject property should not be allowed to be co-mingled with unrelated projects and should be maintained with the lender when possible.

Use Cost/Benefit Analysis Liberally and Frequently

Loan loss statistics do not account for all costs associated with problem loans. Indirect costs, such as legal expenses, administrative expenses, regulatory expenses, personnel expenses, increased funding costs, and lost opportunity costs also have an impact that is not reflected in net charge-off statistics. The direction that management chooses to take when a loan becomes a problem should be based on a cost/benefit analysis that encompasses both direct and indirect costs.[3]

A number of factors must be considered when deciding whether interim restructuring is the best alternative. Alternative strategies should be weighed against management's willingness or unwillingness to solve the problem, the degree to which management believes that the property/project is viable and sustainable, and whether collateral is supportive. Ultimately, the cost of the chosen alternative should be determined and compared against other alternatives prior to implementation. Institutions should determine whether potential outcomes result in a net economic benefit to the institution when all costs and the time value of money are taken into consideration. Some institutions use a decision matrix, or "tree," which helps with selecting the most appropriate strategy, i.e. restructuring, liquidation, long-term workout, etc.

Alternative decisions should not be chosen without substantial management oversight; therefore, final decisions should be reviewed by designated oversight committees or, depending upon the size of the exposure and the institution, the board of directors. This oversight and any thresholds that trigger a higher level of oversight should be memorialized in the problem loan management and workout policy. Other helpful, specific workout policy and procedure considerations are further discussed in the guidance.

A number of factors must be considered when deciding whether interim restructuring is the best alternative.

Summary

These are difficult times for community bankers, particularly those with high concentrations in commercial real estate. Institutions that embrace a pre-emptive approach to problem loan management will be better positioned to reduce losses in the future. Lenders who have a high degree of sensitivity to the more subtle signals of a problem loan, who are disciplined gatherers of intelligence and information, who are creative, and who remain focused will have the best success.

If you would like additional information or have questions about the recent guidance, please contact Sharon D. Wells (sharon.wells@phil.frb.org) at (215) 574-2548 or Ralph Acevedo (ralph.acevedo@phil.frb.org) at (215)-574-6266. Third District institutions are also encouraged to contact their assigned portfolio manager with related institution-specific questions or concerns. ☐

[3] It should be noted that this discussion of costs is limited to inputs associated with evaluating problem loan management alternatives. Lenders should not confuse this cost/benefit analysis with the application of costs allowable under impairment analysis associated with the ALLL, which will be discussed in a separate *SRC Insights* article later in 2010.

Elements of a Sound Funding and Liquidity Risk Management Program, Part I ... continued from page 1

- Comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution
- Active management of intraday liquidity & collateral
- An appropriately diverse mix of existing and potential future funding sources
- Adequate levels of highly liquid marketable securities—free of legal, regulatory, or operational impediments—that can be used to meet liquidity needs in stressful situations
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process

Corporate Governance

Similar to all effective risk management, it is important to remember that effective liquidity risk management starts at the top of the organization. The board of directors is ultimately responsible for the liquidity risk assumed by an institution. It is the board's responsibility to ensure that the institution maintains effective oversight of the liquidity risk management process, and that a proper framework is in place to identify, measure, monitor, and control liquidity risk.

Board members need to be aware of all liquidity risks facing the institution and assign responsibility to management to manage these risks. Board minutes should reflect a review and discussion of pertinent liquidity information, such as a review of the organization's compliance with board-approved liquidity measurement policy thresholds.

Board minutes must be thorough enough to ensure that the institution's liquidity position has been effectively communicated to the board. Board packages should include reports prepared by management that clearly and concisely portray the liquidity profile of the organization. Supplemental liquidity reporting should be provided when necessary to enhance communication to the board. In addition, the board needs to review and approve liquidity policies and procedures, including the bank's contingency funding plan, at a minimum on an annual basis.

Senior management needs to ensure that board-approved liquidity management processes are implemented effectively. Management needs to establish liquidity measurement and monitoring systems that adequately portray the liquidity profile of the institution. Management must ensure that the bank has sufficient liquidity to support daily operations and contingent sources of liquidity, such as highly liquid assets or available lines of credit, that can be utilized for unforeseen liquidity events. Management also needs to ensure that liquidity reports communicate relevant information in an accurate and timely manner.

Committee oversight. Most institutions delegate the oversight of liquidity to the Asset-Liability Committee, or ALCO. To be effective, the ALCO should be composed of individuals from various units of the institution, including, but not limited to, lending, funding, and investments. Examiners thoroughly review ALCO minutes and packages to ensure that pertinent liquidity information is being captured adequately and communicated effectively. In many institutions, a separate Liquidity Committee or Funding Committee has been established to address an institution's funding and/or liquidity needs. These committees likely report to the ALCO, but meet more frequently.

Strategies, Policies, Procedures, and Limits

Examiners expect institutions to have well-documented liquidity strategies and policies and procedures that are commensurate with the size and complexity of the organization. These documents should be reviewed and approved at least annually. Liquidity strategies should set the overall framework for managing liquidity and clearly articulate the risk tolerances of the organization. Policies should translate these strategies into operating standards and should include the following information:

- Authorization to an individual(s) or committee, delineating responsibilities for planning, executing, and reporting
- Primary sources of funding utilized for daily operating activities, as well as sources of back-up liquidity
- Risk tolerance threshold/targets, both quantitative and qualitative
  - Examples include: targeted amount of unencumbered liquid assets, ratios of wholesale funding to total liabilities, funding concentration limits, unfunded loan commitments level, and cash flow mismatches or gaps
- The frequency of the review of the assumptions used in liquidity projections
- The nature & frequency of management reporting

Management should be keenly aware of its wholesale funding capacity from each source and should strive to maintain positive relationships with funds providers.

Diverse funding mix. While institutions may employ various strategies to mitigate their exposure to liquidity risk, two strategies that are often used are: 1) establishing a diversified funding base and 2) creating a cushion of liquid assets. Management should strive to achieve a diversified funding base in terms of funds providers and the tenure of the funding. Overreliance on one funding source heightens a bank's liquidity risk profile and is considered an unsafe and unsound banking practice.

Management should be keenly aware of its wholesale funding capacity from each source and should strive to maintain positive relationships with funds providers. Management must also be aware of the sensitivity of funds providers to changes in the bank's real or perceived financial condition. ALCO and board packages should include a report summarizing the amount of outstanding funds from each wholesale funding source and the remaining capacity with each of these sources.

Adequate levels of highly liquid marketable securities. In addition to having a diversified funding base, institutions should maintain an adequate cushion of unencumbered liquid assets that can be sold or pledged to respond to an unexpected liquidity event. These assets include those that can be readily pledged or converted to cash without undue loss, such as interest-bearing bank balances, fed funds sold, and unencumbered investment securities. Management needs to determine the appropriate level of these assets to hold based on stress-testing analyses. Examiners consider asset liquidity a critical component of proper liquidity risk management.

Internal Controls and Internal Audit Processes

Management should oversee the development and implementation of effective internal controls and review processes for the management of liquidity risk. Liquidity processes should be reviewed by an independent third party on a regular basis to ensure that policies and procedures are being followed. The third party should also assess the adequacy of the bank's risk identification and measurement systems, as well as the reporting process.

Summary

The second article in this two-part series will appear in the third quarter issue of *SRC Insights* and will deal with the essentials and importance of a solid contingency funding plan and effective liquidity risk measurement, monitoring, and reporting.

If you have any questions on liquidity management or liquidity risk management, please contact Andrea Anastasio (andrea.anastasio@phil.frb.org) at (215) 574-6524 or Mark Kemmerer (mark.kemmerer@phil.frb.org) at (215) 574-6156. □

Capital Constraints in Today's Banking Environment

by Eddy Hsiao, Manager

Prolonged distressed economic conditions have seriously hampered earnings and elevated the overall risk profiles of financial institutions. At the same time, institutions are experiencing increased difficulty raising capital in the current environment, and recent accounting rule changes and financial markets stresses have led to negative capital implications for many financial institutions.

This article will highlight three issues that have the potential to impact financial institution capital levels. First, an increased level of reported deferred tax assets may lead to more deductions for regulatory capital. Second, a higher number of downgrades on certain investment securities may result in additional risk-weight asset allocations. And third, the onboarding of previously off-balance sheet assets could cause material regulatory capital consequences for organizations heavily involved in securitizations or other structured finance transactions that utilize special purpose entities.[1]

Regulatory Capital Limits on Deferred Tax Assets
Deferred tax assets (DTAs) arise primarily from two sources:

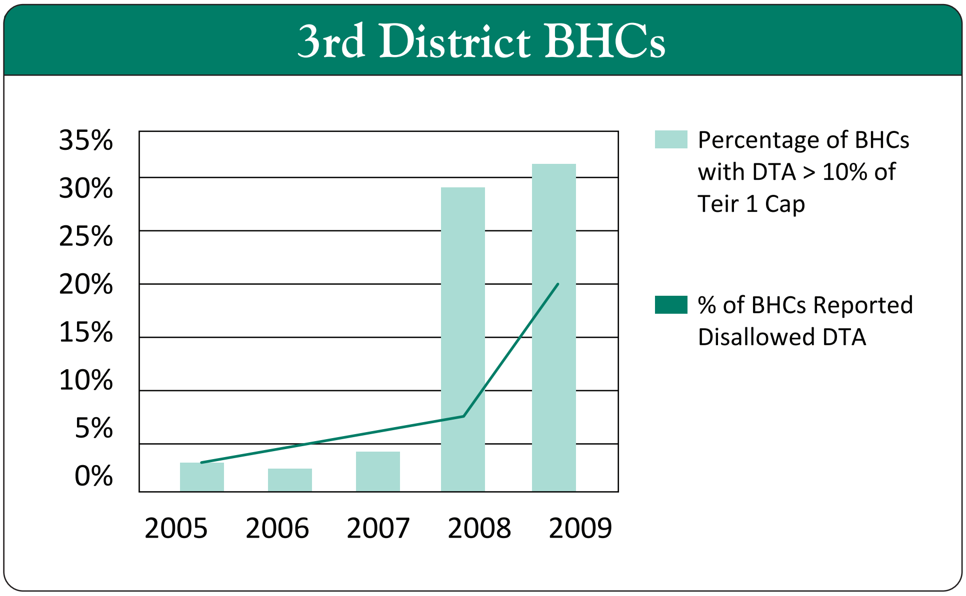
1. Deductible temporary differences on the recognition of income/ expenses for financial reporting versus tax reporting purposes
2. Net operating loss carryforwards

DTAs provide future tax benefits, but are subject to valuation allowance assessments (valuations) as required by generally accepted accounting principles (GAAP) to evaluate how realizable DTA benefits are. Valuations reduce the amount of DTA; earnings; and, therefore, capital. Financial institutions are generally familiar with the accounting rules for valuations, which will not be further discussed in this article; however, some institutions may not realize the additional limitation on the amount of net DTA (i.e., DTA net of valuations and deferred tax liabilities) that can be included (i.e., not deducted) in regulatory capital calculations.

Net DTA included in regulatory capital is limited to the amount the institution expects to realize within one year based on its projected future taxable income or 10 percent of tier 1 capital, whichever is less.

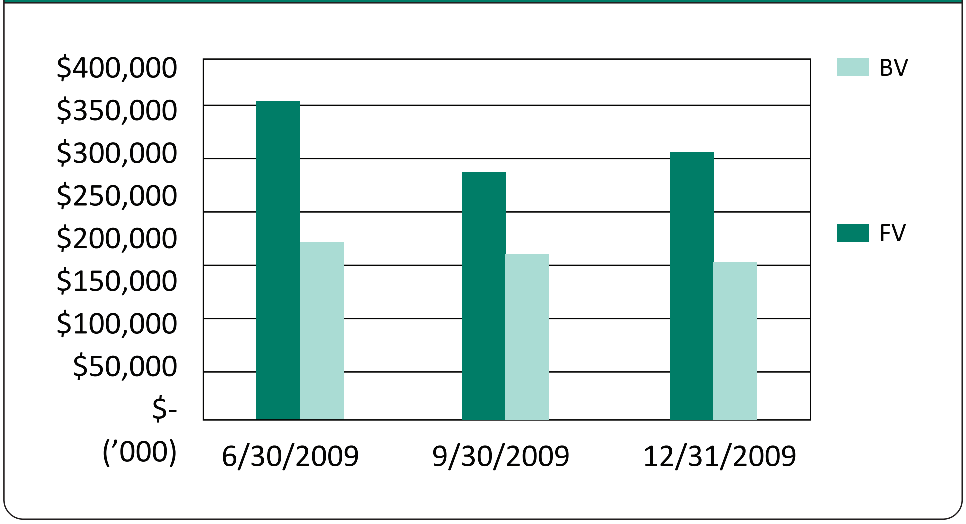
The amount of net DTA in excess of the lesser of these two amounts should be deducted from tier 1 capital.

Financial institution management should follow the worksheet provided in schedule RC-R of the call report or schedule HC-R of FR Y-9C to calculate the amount of disallowed DTA, if any. The growth in DTA, combined with a challenging operating environment,



[1] A technical accounting discussion on these three issues is beyond the scope of this article. This article will highlight the capital implications that may surface from the issues.

ABS & Structured Finance Products-3rd District BHCs



is resulting in increased vulnerability to valuation recognitions and regulatory capital deductions. As such, DTA and the implications for earnings and capital are receiving heightened attention. Management should ensure that adequate documentation is in place to support the assumptions, projections, and calculations for the DTA, valuations, and related regulatory-capital impact.

Downgrades in Certain Investment Securities and Direct Credit Substitutes

Investment securities, especially non-agency securities, have experienced significant depreciation and downgrades by rating agencies over the last few years (see ABS & Structured Finance Products chart). While it is apparent to many financial institutions that the potential for other-than-temporary-impairment recognition and/or regulatory asset classification has risen for these securities, some may have overlooked the regulatory capital impact on certain securities considered direct credit substitutes (DCS) that have been downgraded by rating agencies.

A purchased subordinated security (i.e., in the mezzanine tranche) in a securitization or structured finance program (e.g., collateralized debt obligations) is a DCS. Financial institutions normally adopt an optional ratings-based approach to calculate the risk-weighted asset (RWA) allocation for these securities, which generally results in lower capital requirements.[2] However, if a DCS is rated *more than one category below investment grade* (e.g., below BB-) by a nationally recognized statistical rating organization (e.g., Moody's) or is unrated, it is not eligible for the ratings-based approach. Instead, the institution must hold capital against the amount of the securities it holds plus its pro rata share of the more senior positions in the securitization or structured finance program.

Essentially, this method, also referred to as the "gross-up" approach, does the following:

1. Sums up the face amount of the subordinated security and the pro rata portion of all of the more senior positions currently outstanding in the securitization that the security supports
2. Allocates risk weights to the resulting amount based on the risk weight of the assets underlying the securitization

However, if the minimum capital charge (i.e., 8% X RWA calculated under the gross-up approach) for the RWA amount is greater than the maximum contractual exposure on its investment (i.e., face amount of the purchased subordinated security), then the low level exposure rule would be applied to limit the risk-based capital requirement to the maximum contractual loss exposure. The low-level exposure rule

[2] Information on the ratings-based approach and the low-level exposure rule are included in the instructions for Call Report Form FFIEC 041, Schedule RC-R, available online at <www.ffiec.gov/forms041.htm>.

[3] *Examples of Reporting an On-Balance Sheet Security that is a Direct Credit Substitute Not Eligible for the Ratings-Based Approach in Call Report Schedule RC-R-Regulatory Capital* is available on the Federal Financial Institutions Examination Council's website at <www.ffiec.gov/forms041.htm>.

essentially imposes a dollar-for-dollar capital requirement on the purchased subordinated security.

Some institutions were not aware of the more stringent capital requirements when subordinated securities were downgraded to below BB- and failed to allocate sufficient RWA to these securities. In a few instances, the capital impact was significant enough to cause the institution's capital designation under Prompt Corrective Action to drop from "well capitalized" to "adequately capitalized." Instructions and clarification on the calculation and reporting of capital requirements for DCS can be found in the call report instructions and the supplemental guidance, *Examples of Reporting an On-Balance Sheet Security that is a Direct Credit Substitute Not Eligible for the Ratings-Based Approach in Call Report Schedule RC-R-Regulatory Capital*.[3]

Changes in Sale Accounting and Consolidation of Off-Balance Sheet Vehicles

On June 12, 2009, FASB finalized modifications to FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FIN46(R), *Consolidation of Variable Interest Entities*, through the issuance of FAS 166 and FAS 167, respectively, which are effective on January 1, 2010, for organizations with a calendar year-end.

FAS 166 and FAS 167, which were codified in Accounting Standards Codification (ASC) numbers 860 and 810, respectively, changed the accounting treatment for securitizations and certain transactions that were previously kept off-balance sheet. Arrangements that will likely be moved on-balance sheet pursuant to the accounting-rule changes include asset-backed conduits, non-agency loan securitizations, credit card securitizations, and loan participations that do not meet certain criteria (i.e., pro rata sharing of cash flow).

Many institutions affected by these changes have already anticipated (some through the Federal Reserve's Supervisory Capital Assessment Program) the potential regulatory capital impact from the onboarding or consolidation of previously off-balance sheet assets. The highly awaited regulatory final risk-based capital rule (final rule) amending the risk-based capital rules to reflect the issuance of FAS 166 and FAS 167 was issued by the regulatory agencies in January 2010.[4]

Many institutions affected by these changes have already anticipated (some through the Federal Reserve's Supervisory Capital Assessment Program) the potential regulatory capital impact from the onboarding or consolidation of previously off-balance sheet assets.

The final rule does not provide exemptions or regulatory capital relief to onboarded assets; however, it does allow an optional transition mechanism to delay and phase in the impact on risk-weighted assets. In general, the final rule provides financial institutions the option to exclude the allocation of RWA to the consolidated assets for the first two quarters (exclusion period) after the date it implements the new accounting rule, followed by two quarters (phase-in period) of not including 50 percent of RWA associated with the amount excluded in the first two quarters. To align with the transition mechanism provided for the allocation of RWA during the exclusion and phase-in periods, the final rule also allows an FI to delay the calculation of the 1.25 percent tier 2 capital limit on the allowance for loan and leases losses related to the consolidated assets.

Furthermore, the final rule includes a new reservation of authority, which allows banking agencies to require institutions to treat an unconsolidated entity based on accounting requirements as a consolidated entity for regulatory risk-based capital purposes. It is

[4] The interagency press release is available on the Board of Governors' website at <www.federalreserve.gov/newsevents/press/bcreg/20100121a.htm>.

also important to point out that while the transition mechanism delays the impact on risk-based capital ratios, the same benefit is not applicable to the tier 1 leverage ratio, which is calculated based on average assets rather than RWA.

These accounting changes appear to have a greater effect on large financial institutions due to more securitization activity and variable-interest entity transactions. For smaller institutions, close attention should be paid to the impact on loan participations. In order to receive sale treatment, institutions should ensure that the participation transaction does not contain disproportionate ownership rights and unequal priority to each participating interest holder, recourse obligations other than standard representation and warranties, or subordination or prioritization in the receipt of payments. Otherwise, the participation would not receive sales treatment.

Summary

Capital is one of the most critical components of a financial institution's overall financial condition. In today's operating environment, it has been quite challenging for financial institutions to maintain capital levels and raise new capital, as widespread operating losses and asset quality concerns erode capital and undermine public confidence. Exacerbating the situation is the additional negative impact on regulatory capital resulting from market deteriorations and recent accounting changes. An institution's management should consult with its accountants and banking regulator if it is uncertain about the regulatory capital implications that may result from the issues discussed in this article. For questions or more information, contact Banking Surveillance Manager Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215) 574-3772. □

Recently Released Supervision and Regulation Letters

- **SR 10-12** Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions: Issued June 7, 2010
- **SR 10-11** Interagency Examination Procedures for Reviewing Compliance with the Unlawful Internet Gambling Enforcement Act of 2006, Issued May 20, 2010
- **SR 10-10** Interagency Guidance on Correspondent Concentration Risk Cross: Issued April 30, 2010
- **SR 10-9** Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual: Issued April 29, 2010
- **SR 10-8** Suspicious Activity Report Filing Requirements for Banking Organizations Supervised by the Federal Reserve: Issued April 27, 2010
- **SR 10-7** Comments to the Basel Committee on Banking Supervision Regarding Proposals to Strengthen the Resiliency of the Banking Sector: Issued March 25, 2010
- **SR 10-6** Interagency Policy Statement on Funding and Liquidity Risk Management: Issued March 17, 2010
- **SR 10-5** Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information: Issued March 5, 2010
- **SR 10-4** Clarification of the Risk Weight for Claims on or Guaranteed by the Federal Deposit Insurance Corporation (FDIC): Issued February 26, 2010
- **SR 10-3 FFIEC** Retail Payment Systems Booklet: Issued February 26, 2010

ll SR Letters are available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/>.

Regulatory Applications Filing Is New and Improved!

Introducing the Regulatory Applications Electronic Submission System

by Judy Lynn, Senior Specialist

Has your organization recently had to file a regulatory application with the Federal Reserve Bank of Philadelphia to open a new branch, form a bank holding company, or perhaps complete a merger? Are you aware of the benefits for regulatory applications filers (filers) who have signed up for authorization to submit via the Federal Reserve's electronic filing system, known as E-Apps? With a few simple clicks of a mouse, your regulatory application can be easily submitted to the Federal Reserve, eliminating the need for time-consuming and costly copies and postage and reducing potential processing delays.

The public release of E-Apps occurred in the first quarter of 2010. E-Apps can now be used by banks and bank holding companies or by their representative attorneys and consultants to submit, in a secure environment, the regulatory applications associated with obtaining approval or providing notice to the Federal Reserve under Regulation Y[1] for bank holding companies and Regulation H for state member banks.[2] Gone are the days of submitting multiple copies of all documents—filers simply attach a file(s) and hit "send." The Federal Reserve immediately receives the file(s), and a confirmation number is returned. The system is so easy to use that filers can access the system and complete a filing in as little as five minutes!

Is It Secure?

In one word: Yes! The Federal Reserve is keenly aware of the sensitive nature of the information filers submit. To protect filers, the Federal Reserve has gone to great lengths to provide a secure environment where filers can rest assured that their confidential data will be safe from the prying eyes of Internet hackers. Of course, as in the world of paper processing, the Federal Reserve does release the non-confidential sections of regulatory filings upon request.

How Do I Get Started?

A few steps need to be completed prior to accessing E-Apps. The E-Apps webpage has all of the required forms, instruction briefs, and E-Apps FAQs filers need. It is located at <www.federalreserve.gov/bankinforeg/eappssignup.htm>.

Step 1: **Complete the required forms.** Financial institutions filing on their own behalf **must** appoint **at least one** authorizing officer for their organization. If preferred, a law firm or other agent may be designated as an agent official to file on the firm's behalf. Additionally, a law firm can start the process on its own and sign up its clients on an as-needed basis.

The required forms and associated instructions to designate an authorized officer, agent official, and filing employee are located on the E-Apps webpage, or institutions and agent firms can contact the Federal Reserve Customer Care Center (CCC) dedicated to their District to obtain the necessary forms. All forms must be submitted to the CCC.

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[1] At present, the system cannot be used for Change in Bank Control requests.
[2] A complete list of filing types that may be submitted via E-Apps is available on the Board of Governors' website at <www.federalreserve.gov/bankinforeg/eapps.htm>.

For the Third District:

Customer Contact Center
P.O. Box 219416
Kansas City, MO 64121-9416
(800) 333-2690 or (816) 881-2690, Option 2

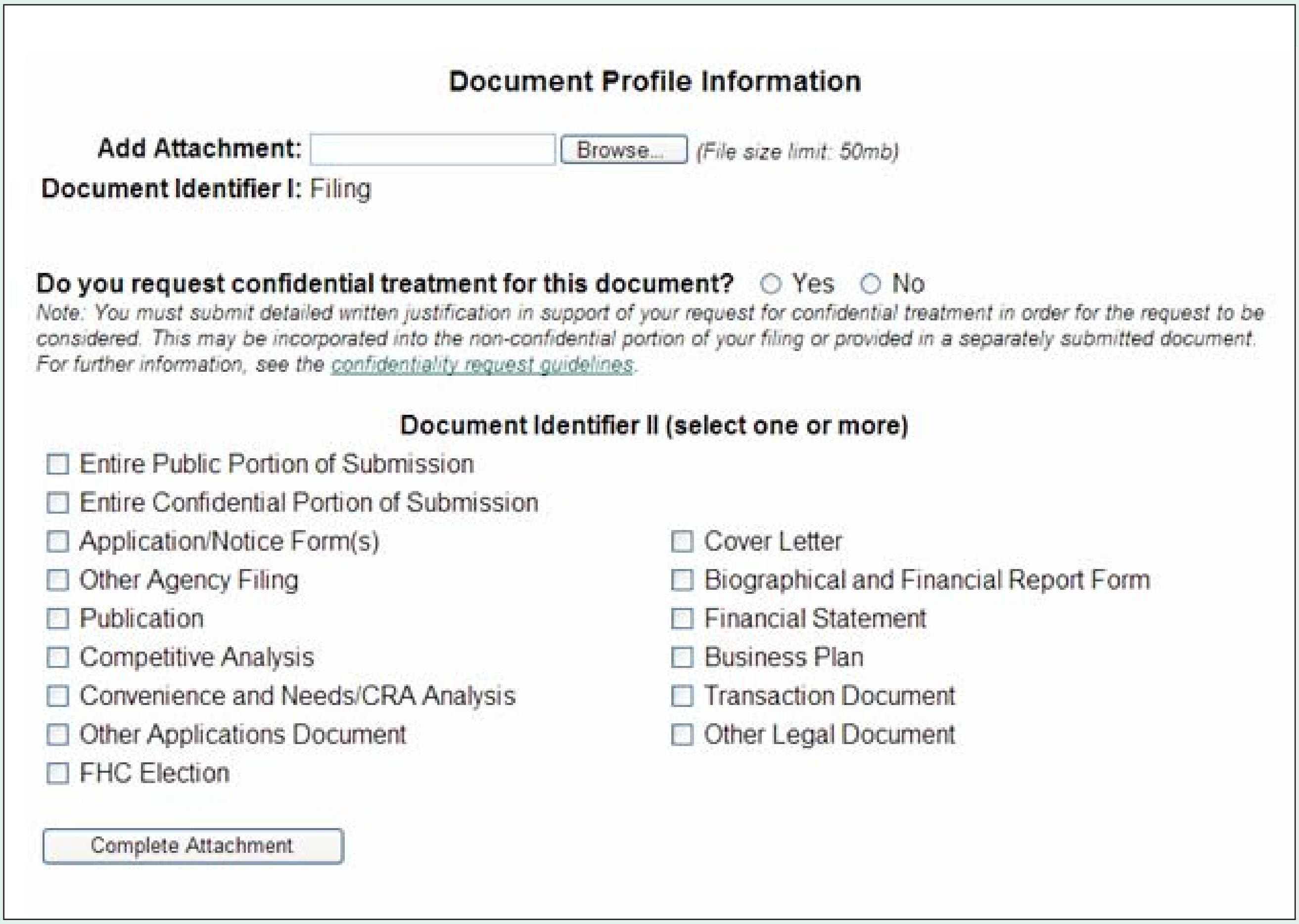
Step 2: **Submit forms and receive a digital certificate.** Upon submission of the required forms, the designated filing employees will receive a digital certificate to access E-Apps.[3] This certificate, which is issued by the Federal Reserve System, confirms their identity to E-Apps and includes a password protection security layer.

Once all required forms are reviewed and approved by the CCC, digital certificates are issued via email, accompanied by the instructions for downloading the certificate. Assistance is also available from the CCC. Once the digital certificate is properly installed on the filer's computer, the E-Apps system can be accessed immediately.

Step 3: **Access E-Apps!** The link to log on to E-Apps is located on the E-Apps webpage. E-Apps was designed to work with Microsoft® Internet Explorer® and operates most effectively with a broadband Internet connection. Click the "Start the Filing Process" link as shown on the Welcome screen below. Filing choices include: create a new filing, amend an existing filing, or submit prefiling documents (typically publication and name check requests).

Once you have selected the appropriate filing category, you will select which company(ies) you are filing for, which will then bring up the document attachment screen. Simply browse and select the proper file(s), indicate the confidentiality of the document, and then select a document identifier. E-Apps accepts all common file types, including pdfs, Word, and Excel. Then, click the button at the bottom of the screen to "Complete Attachment." Continue the process until you have all of the documents for the filing attached. Each document attached will appear in a table at the bottom of the page for your convenience.

When all files have been attached, click the "Continue" button on the bottom of the page. This brings you to the legal certification page, which requires you to agree to the terms and conditions. To affirm, click "Accept and Submit Filing." Immediately thereafter, you will receive a confirmation number and a time stamp from the E-Apps system. That's it!



Document Profile Information

Add Attachment: [ ] Browse... *(File size limit: 50mb)*

Document Identifier I: Filing

Do you request confidential treatment for this document? ○ Yes ○ No

Note: You must submit detailed written justification in support of your request for confidential treatment in order for the request to be considered. This may be incorporated into the non-confidential portion of your filing or provided in a separately submitted document. For further information, see the confidentiality request guidelines.

Document Identifier II (select one or more)

- ☐ Entire Public Portion of Submission
- ☐ Entire Confidential Portion of Submission
- ☐ Application/Notice Form(s)
- ☐ Other Agency Filing
- ☐ Publication
- ☐ Competitive Analysis
- ☐ Convenience and Needs/CRA Analysis
- ☐ Other Applications Document
- ☐ FHC Election
- ☐ Cover Letter
- ☐ Biographical and Financial Report Form
- ☐ Financial Statement
- ☐ Business Plan
- ☐ Transaction Document
- ☐ Other Legal Document

Complete Attachment

What Happens After I Submit via E-Apps?

Once you accept and submit your files, the Federal Reserve Bank of Philadelphia Regulatory Applications staff are alerted via automatic email that a new filing or other filing documents have been submitted through E-Apps. Staff then access the system and assign the filing to the proper staff members, both in Philadelphia and at the Board of Governors. What used to take days in the paper world to reach the Board can now be sent in seconds! Standard regulatory timeframes still govern when a filing can be acted upon, but the benefit to faster submissions and distribution is that issues can be identified and resolved earlier in the process, potentially avoiding extension delays.[4]

After submitting an electronic filing, both an email and on-screen confirmation are generated. When filing on behalf of a financial institution, the authorized official will also receive an email confirmation.

So, what are you waiting for? Sign up today!

The local E-Apps expert at the Federal Reserve Bank of Philadelphia is Judy Lynn (judy.lynn@phil.frb.org), and her phone number is (215) 574-6171. She can assist you in gaining access for your organization or banking clients, completing the forms, accessing Internet links, or any other question related to E-Apps.

What current E-Apps users are saying:

"We saved over $200.00 in copy and courier fees!"
"What a timesaver!"
"I'll never have to take a filing to the post office again!"
"It only took a few minutes to file the entire application!"

[3] A digital certificate is a type of electronic key or access component issued by the Federal Reserve System as a security measure to ensure that only authenticated filers are permitted access to E-Apps. Your certificate will reside on your computer, and you will be the only person who can use it. You will receive only one certificate, regardless of the number of institutions on behalf of which you are authorized to act. Your organization can request digital certificates for as many filers as needed.

[4] Please note: There is no requirement to file electronically, and E-Apps submissions do not receive preferential treatment.

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Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

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